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United States Business: United States Branch versus United States Corporation**

The new branch profit tax, enacted by the Tax Reform Act of 1986,[1] contains a plethora of problems related to retaining assets in the United States, financing non-U.S. projects, and guessing the meaning of indirect payments for purposes of the base erosion test. Yet, while the new branch profit tax has a peculiar application to foreign corporations owned entirely by U.S. citizens, its provisions provide flexibility in interest payments. In effect the tax condones treaty shopping by foreign shareholders or creditors of U.S. corporations. Because the branch profit tax is assessed against foreign corporations, applicable tax treaties must be analyzed carefully.[2]

I. Prior Law

Prior to the Tax Reform Act of 1986, dividends and interest paid by a foreign corporation engaged in a U.S. trade or business to nonresident individuals or foreign corporations were generally subject to a withholding tax if the gross income threshold was met. This threshold required that 50 percent or more of the foreign corporation's gross income for the three taxable years immediately preceding the year the interest was paid or the dividend declared was effectively connected with a U.S. trade or business.[3] Once this threshold was met and no limiting treaty or Code provision existed, only a percentage of dividends or interest equal to the

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1. The Tax Reform Act of 1986, (codified at 26 U.S.C. § 884 (Supp. IV 1986)). Pub. L. No. 99-514, § 1241, 100 Stat. 2085, 2576.

2. The Internal Revenue Service has identified treaties that preclude or permit the branch profit tax for qualified residents. I.R.S. Notice 87-56, 1987-35 I.R.B. 9.

3. I.R.C. § 861(a)(1)(C), (a)(2)(B) (1982).

percentage of total gross income effectively connected with a U.S. business was subject to withholding at a 30 percent rate.[4]

Some treaties eliminate such withholding,[5] reduce the rate of withholding,[6] or require a minimum gross income threshold at least equal to the 50 percent threshold discussed above.[7] In addition, certain Code provisions exempt portfolio interest,[8] interest on deposits,[9] and original issue discount obligations with six-month or less maturities[10] from withholding.

One Code provision, preceding the Tax Reform Act of 1986, broadened the base for withholding by treating all interest paid or credited by a U.S. branch of a foreign corporation as U.S. source income if such branch was engaged in the commercial banking business.[11] This provision, therefore, subjected this branch interest to U.S. withholding taxes unless a treaty exemption or a Code exemption, such as interest on deposits, portfolio interest, or original issue discount, existed.

II. Reasons for Change

The Conference Committee Report provides that the purpose of the new branch profit tax is to reduce the tax disparity between U.S. earnings dispositions by U.S. corporations and U.S. branches of foreign corporations.[12] Prior to the Tax Reform Act of 1986, this disparity resulted from a second-level withholding tax imposed on dividends paid by a U.S. corporation to foreign persons while the export of U.S. earnings by a U.S. branch of a foreign corporation to its non-U.S. operations was tax-free. The result was discrimination against United States corporations.[13]

The Committee Reports made it apparent that Congress was concerned with "treaty shopping," whereby a corporation that would exceed the gross income thresholds discussed above would incorporate under the

4. I.R.C. §§ 861(a)(1)(D), (a)(2)(B), 871(a)(1), 881(a).

5. Japanese Income Tax Treaty, Mar. 8, 1971, United States-Japan, arts. 6, 7, 12, 23 U.S.T. 967, 977, 981, 988, T.I.A.S. No. 7365, *reprinted in* 2 Tax Treaties (CCH) ¶¶ 4393F, 4393G, 4393L.

6. French Income Tax Treaty, July 28, 1967, United States-France, arts. 9, 13, 24, 19 U.S.T. 5280, 5292, 5299, 5310, T.I.A.S. No. 8680, *reprinted in* 2 Tax Treaties (CCH) ¶¶ 2812, 2816, 2827.

7. Norwegian Income Tax Treaty, Dec. 3, 1971, United States-Norway, arts. 5, 8, 25, 23 U.S.T. 2834, 2840, 2842, 2855, T.I.A.S. No. 7474, *reprinted in* 3 Tax Treaties (CCH) ¶¶ 6058, 6061, 6078.

8. I.R.C. § 871(h).

9. I.R.C. § 861(c).

10. I.R.C. § 871(g).

11. I.R.C. § 861(a)(1)(D), Treas. Reg. § 1.861-2(b)(3)(iv) as revised in (1972).

12. H.R. Rep. No. 841, 99th Cong., 2d Sess. 649 (1986), [hereinafter Conference Committee Report].

13. S. Rep. No. 313, 99th Cong. 2d Sess. at 401 (1986), [hereinafter Senate Finance Report].

laws of a country such as Greece, whose treaty with the United States provided an exemption from the withholding tax on dividends and interest. The Senate Finance Report suggested that a withholding tax scheme using a worldwide gross income threshold was difficult for the Internal Revenue Service to enforce.[14] The Senate Finance Report also indicated that prior thresholds were arbitrary and that any jurisdictional nexus would be met by a branch tax.[15]

III. Branch Profit Tax—Overview

Internal Revenue Code (IRC) section 884 is effective for taxable years after December 31, 1986. Under the new branch profit tax scheme, the foreign corporation is a taxpayer rather than a withholding agent. The branch profit tax is applied to the foreign corporation's "dividend equivalent amount" without any consideration of the foreign corporation's worldwide gross income and without any minimum threshold requirements. The label of the branch profit tax is misleading because, as will be discussed later, the tax applies only to U.S. profits that are remitted to non-U.S. operations. If the U.S. profits are reinvested in a U.S. trade or business, no branch profit tax is imposed even if the foreign corporation is treaty shopping. Subject to treaty reduction if no treaty shopping exists, the tax is 30 percent of the U.S. branch profits exported outside the United States. This tax is the dividend equivalent amount. Because the U.S. branch is treated as a U.S. subsidiary, the applicable parent subsidiary withholding rate of the treaty in which the foreign corporation operating in the United States is a qualified resident may reduce the withholding rate below 30 percent.[16]

The effect of the branch profit tax can be illustrated as follows:

	1986		1988	
	U.S. Corp.	**Foreign Corp.**	**U.S. Corp.**	**Foreign Corp.**
Taxable Income	$100	$100	$100	$100
U.S. Corporate Tax	−46	−46	−34	−34
Dividend Equivalent Amount	54	54	66	66
30% Withholding Tax on Repatriation	−16	*	−20	−20
Earnings Useable Outside U.S.	$ 38	$ 54	$ 46	$ 46

*This assumes that either (1) the foreign corporation's U.S. gross income does not exceed 50 percent (25 percent after 1986) of the foreign corporation's total gross income or (2) the foreign corporation used the funds itself in non-U.S. operations.

14. Senate Finance Report, *supra* note 13, at 401.
15. Senate Finance Report, *supra* note 13, at 401–402.
16. I.R.C. § 884(e)(2)(A)(ii) (Supp. IV 1986).

A. Interest

Also buried in the branch profit tax provisions of IRC section 884 are sweeping changes concerning the withholding or taxation of interest paid, or "excess interest," of a U.S. branch of a foreign corporation. As under the branch profit tax scheme, threshold U.S. gross income requirements are eliminated.[17] This new interest taxation scheme bifurcates the interest expense of the U.S. branch into two components: (1) interest actually paid by the U.S. branch and (2) any interest deducted by the U.S. branch for regular U.S. income tax purposes in excess of interest paid by the U.S. branch, that is "excess interest."[18]

Any interest actually paid by the U.S. branch is treated as if paid by a U.S. corporation and thus is subject to withholding unless a Code exemption, such as portfolio, bank, or original issue discount interest, applies. Any withholding tax is still considered to be a tax imposed on the interest recipient. Treaty benefits are determined under the treaty between the United States and the country in which the interest recipient is a qualified resident or the country of residence of the foreign corporation operating in the United States if the treaty has a "source" interest exemption.[19]

Any interest in excess of the amount paid by the U.S. branch and allocated to the branch under IRC section 882 in determining the branch's effectively connected U.S. earnings for purposes of the regular U.S. income tax is also subject to a tax that is imposed on the foreign corporation and not on the interest recipient.[20] Such interest may be exempt, however, under a Code provision that allows for "looking through" to the nature of the excess interest, for example portfolio interest, bank deposit interest, or original issue discount interest.[21] Treaty benefits are determined by considering the excess interest as paid to the foreign corporation by a wholly owned U.S. corporation; thus, the treaty of the country in which the foreign corporation is a qualified resident is relevant. That treaty's parent-subsidiary withholding rate or similar provision would control if the foreign corporation operating in the United States is a qualified resident of its country of domicile. If the foreign corporation is subject to tax in its country of residence on these U.S. operations, and its country of residence employs a foreign tax credit system comparable to that of the United States, it is possible that this U.S. tax or such excess interest

17. I.R.C. § 884(f).
18. *Id.*
19. IRS Notice 87-56, *supra* note 2.
20. I.R.C. § 884(f)(1)(B).
21. Conference Committee Report, *supra* note 12, at 650.

may not be creditable against foreign taxes since the tax is not tied to "income" of the foreign corporation.[22] Thus, proper capitalization of the foreign corporation—debt versus equity—will gain additional importance, as will the source of interest payments, that is, interest paid by the branch versus interest paid by the foreign home office. Discussion of these considerations follows later in this article.

B. Dividend Equivalent Amount

IRC section 884 imposes the branch profit tax on the "dividend equivalent amount." This dividend equivalent amount consists of the earnings and profits "effectively connected" with a U.S. trade or business for the taxable year adjusted (1) downward by net increases in "U.S. net equity" or (2) adjusted upward by net decreases in "U.S. net equity." IRC section 884(b)(2)(B) places a ceiling on the cumulative upward adjustments equal to cumulative downward adjustments. This ceiling is designed to protect pre-1986 branch earnings from the new branch profit tax as well as to protect post-1987 capital infusions from the branch profit tax when later repatriated since such capital infusions could not reduce current year earnings and profits below zero under IRC section 884(b)(1). Because current year "earnings and profits" is the starting point, IRC section 316 provides that current year's earnings and profits could be taxed even if there is a cumulative deficit in earnings and profits. Therefore, assets should be repatriated from the United States in those years preceding any years expected to be profitable.

Additionally, no credit or carryover is given later for prior year investments in the U.S. branch that exceeded the amount necessary to protect that prior year's earnings and profits from the branch profit tax. Because, however, IRC section 884(b)(1) limits U.S. net equity increases to current year earnings and profits, and because subsequent U.S. net equity decreases under IRC section 884(b)(2)(B) are taken into account only to the extent of cumulative U.S. net equity increases, these capital infusions will be protected from the branch profit tax when later exported out of the United States. This capital protection effect can be illustrated by the following example:

Building cost: $100,000. Annual depreciation: $5,000.
Rental cost: $20,000. Cash cost of ownership: $15,000.

A continuation of this example for ten years will result in an additional $100,000 of U.S. cash in the United States. Under IRC section 884(b)(1)

22. *See* I.R.C. § 901 *et seq.*

Year 1	Ownership	Rental
Earnings and Profits	$ 20,000	$20,000
Increase in U.S. Equity		
Beginning of Year U.S. Equity		
Cash	10,000	10,000
Building	-0-	-0-
	10,000	10,000
End of Year U.S. Equity		
Cash	(35,000)	(30,000)
Building	(95,000)	-0-
	(130,000)	(30,000)
Dividend Equivalent Amount	-0-	-0-
Ending Cash	35,000	30,000
Increase in U.S. equity not considered (130,000-10,000-20,000)	$100,000	$ -0-
Year 2		
Earnings and Profits	$ 20,000	$20,000
Increase in U.S. Equity		
Beginning of Year U.S. Equity		
Cash	35,000	30,000
Building	95,000	-0-
	130,000	30,000
End of Year U.S. Equity		
Cash	(60,000)	(50,000)
Building	(90,000)	-0-
	(150,000)	(50,000)
Dividend Equivalent Amount	-0-	-0-
Ending Cash	60,000	50,000
Increase in U.S. equity not considered	$100,000	$ -0-

and IRC section 884(b)(2)(B), however, this additional cash will not be subject to the branch profit tax because up to $100,000 of U.S. net equity decreases can be sustained without affecting the dividend equivalent amount. Such cash build-ups in the United States, however, should be avoided and any excess cash exported out of the United States, if the limitation under IRC section 884(b)(2)(B), as just discussed, will prevent the branch profit tax, since excess cash may not be considered an asset connected with a U.S. trade or business.

C. U.S. Earnings and Profits

The concept of U.S.'s effectively connected earnings and profits is relatively easy for foreign tax professionals. Effectively connected income is already calculated under IRC section 882 for regular U.S. income tax purposes. The 1986 Tax Reform Act substantially changed source rules that, under IRC section 864(c)(3), play a major role in determining U.S. effectively connected income.

IRC section 884(d)(2) excepts the following income from earnings and profits: (1) earnings from the operations of ships or aircraft that are exempt by reason of a treaty or reciprocal exemption; (2) certain foreign sales corporation income and distribution; (3) gain on the disposition of a U.S. corporation that is treated as a U.S. real property interest under IRC section 897(c)(1)(A)(ii); and (4) earnings of insurance companies treated as effectively connected under IRC section 953(c)(3)(C). United States' effectively connected income is then adjusted to "earnings and profits" under IRC section 312 and applicable case law.

It would appear that variations between expenses actually paid by the U.S. branch and expenses allocated to the U.S. branch under IRC section 882 should not be adjustments to U.S. earnings and profits. One court has held that the dividends received-deduction does not reduce earnings and profits because no corporate resources have been used.[23] To deny allocated deductions yet allow paid deductions for U.S. earnings and profits purposes would be inappropriate. Deductible payments are, in effect, earnings repatriations, and allocated deductions leave a like amount of U.S. earnings available for repatriation without imposition of the branch profit tax.[24]

D. U.S. Net Equity

United States net equity is a new concept and its illusivity is likely to result in considerable litigation. IRC section 884(c) defines U.S. net equity as the excess of the adjusted bases for earnings and profits purposes of assets connected with the U.S. business over the liabilities connected with the U.S. trade or business. IRC section 884(c)(2)(C) empowers the Secretary of the Treasury (the Secretary) to prescribe regulations for determining U.S. business-connected assets and liabilities that are consistent with the allocation of deductions under IRC section 882(c)(1).

E. U.S. Business-Connected Assets

IRC section 882(c)(1) does not provide guidance for determining allocable U.S. deductions, but provides the Secretary authority to prescribe regulations. Treasury Regulation section 1.882-4 provides that all ex-

23. Weyerhaeuser v. Commr, 33 B.T.A. 594, 597 (1935).
24. For a further discussion, see *infra* subsection P.

penses other than interest are to be allocated as provided by Treasury Regulation section 1.861-8. Neither regulation mentions the allocation of assets. The interest allocation rules of Treasury Regulation section 1.882-5, however, consider all assets that give rise, or could give rise, to effectively connected U.S. business income.

One must apply IRC section 864 principles in order to determine which assets are effectively connected with a U.S. business. The complexities involved can be illustrated by the following examples. In the case of capital gain and other fixed or determinable annual or periodic income, IRC section 864(c)(2) provides that income is effectively connected only if the asset giving rise to it, or the asset that could give rise to it,[25] is used or held for use in the business, or if the income arises, or could arise,[26] directly from the active conduct of a U.S. trade or business. In many cases, nonproductive assets must be viewed as if they produced income in order to determine whether the "hypothetical income," and thus the asset, is effectively connected with a U.S. trade or business. In addition, some classes of foreign source income are considered effectively connected with a U.S. business under IRC section 864(c)(4) if the income is attributable to an office or other fixed place of business of the foreign corporation in the United States.

Cash is normally used to pay expenses or purchase assets and only indirectly produces any income. The Senate Finance Committee intends, however, that effectively connected U.S. assets should include "cash necessary to meet day-to-day operating requirements."[27]

F. Retention of U.S. Profits

To avoid the branch profit tax, a foreign corporation may choose to leave its U.S. profits in the United States. If the U.S. business is profitable, the branch will build up cash reserves likely to exceed an amount "necessary to meet day-to-day operating requirements,"[28] or the branch will build up investments not likely to "be used or held for use in the business." In addition, it is not likely that the branch's income will directly arise from the active conduct of the U.S. business.[29] In these cases, the assets will lose their status as effectively connected with a U.S. business, and "U.S. net equity" will be reduced by a similar amount. This occurrence will subject all or a portion of the branch's profits to the IRC section 884

25. *See* Treas. Reg. § 1.882-5 (1954).
26. *Id.*
27. Senate Finance Report, *supra* note 13, at 404.
28. *Id.*
29. I.R.C. § 864(c)(2).

branch profit tax because U.S. net equity will decrease under the mechanics of IRC section 884(b).

These results may seem nonsensical and indeed they are when one considers that the alleged purpose of the branch profit tax is to reduce the disparity between U.S. earnings distributions to foreign shareholders by U.S. corporations and by U.S. branches of foreign corporations.[30] United States corporations are not subject to a comparable tax and, if anything, the tax law now discriminates against the foreign corporation. If the foreign corporation has engaged in "treaty shopping," in that it is not a "qualified resident" of the treaty country as defined by IRC section 884(d)(4), then it cannot receive relief under the treaty's nondiscrimination article.[31] If the foreign corporation is a "qualified resident" of the treaty country, the foreign corporation will not be subject to the branch profit tax at all if the treaty contains a nondiscrimination article. If the situation is other than the latter, one might argue the existence of a discriminatory impact on imports or foreign corporations.

Treating these assets as business-connected might also deny tax benefits if the assets generate either portfolio income, bank deposit earnings, or income treated favorably under a tax treaty. This result derives from the fact that portfolio income and bank deposit earnings as well as some types of income defined in a treaty are exempt from U.S. tax only if such assets are not connected with a U.S. trade or business.[32]

An obvious alternative would be to reduce these liquid assets by expanding the U.S. business into new geographic areas or new products. Another possible alternative is to invest the U.S. profits into corporate stock. Because this stock will at most generate dividend income, this asset would not likely meet the tests imposed by IRC section 864(c)(2) and Treasury Regulation section 1.882-5, which require that the asset must, or could, generate income arising directly from the active conduct of a U.S. trade or business in order for the income, and thus the asset, to be treated as effectively connected U.S. business income. In addition, Treasury Regulation section 1.864-4(c)(2)(iv) limits such stock investments to the "present needs" of the U.S. business.

The Conference Committee Report suggests, however, that an investment by the U.S. branch in corporate stock can constitute an increase in its effectively connected business assets. The Conference Committee Report indicates that the regulations should require that the tax base be

30. *See* Senate Finance Report, *supra* note 13, at 401.
31. Senate Finance Report, *supra* note 13, at 405.
32. I.R.C. §§ 881(c), 881(d).

decreased if the branch tax would not have been imposed had the corporate assets, rather than corporate stock, been acquired.[33]

Another alternative would be to incorporate the branch as a U.S. corporation because U.S. corporations are not subject to the branch profit tax even if such U.S. corporations have other non-U.S. operations.[34] In Notice 86-17 (December 12, 1986), published in Internal Revenue Bulletin B-1986-52, the Internal Revenue Service (IRS) ruled that the branch profit tax would not be imposed where the branch's assets and liabilities are transferred to a new U.S. corporation in an IRC section 351 transaction. Since an IRC section 351 transaction and a purchase of U.S. corporate stock has no difference in substance, the branch profit tax should arguably not be taxed in a stock purchase situation. Of course, reasonable limitations on the size of the stock investments should be imposed.[35]

The Conference Committee's allowance of certain stock purchases should cover purchases of U.S. corporations that conduct only U.S. business. If the U.S. corporations conduct foreign business, only the assets of the acquired U.S. corporation that would qualify as connected with a U.S. trade or business should qualify. This procedure would treat an equivalent percentage of the corporation's outstanding stock as qualifying as business-related. For example, if 60 percent of the U.S. corporation's assets are connected with a U.S. trade or business, and the U.S. branch of a foreign corporation purchases 70 percent of the U.S. corporation's outstanding stock, then 42 percent (60 percent multiplied by 70 percent) of the stock purchase cost should qualify as connected with a U.S. business. Regulations should establish some minimum amount of U.S. business that a U.S. corporation must conduct in order for a portion of its outstanding stock to qualify as the U.S. business-connected asset. Perhaps the 80-20 test of IRC section 81(c)(1) should apply to make a portion of the U.S. corporation's stock a U.S. business-connected asset so long as the U.S. corporation is not an 80-20 corporation as defined by IRC section 861(a)(1)(A).

Perhaps another alternative is the stock purchase of a U.S. corporation with high-basis, low-value assets followed, after an appropriate period of time, by a liquidation of the U.S. corporation under IRC section 332. Because the foreign corporation, and its U.S. branch, will take the basis of the assets received as the transferee's basis under IRC section 334(b), this purchase will allow an amount of U.S. earnings and profits, equal to the excess of the inherited basis of the assets received in liquidation over the basis of the assets used to make the stock purchase, to be exported

33. CONFERENCE COMMITTEE REPORT, *supra* note 12, at 648.

34. I.R.C. § 884(a).

35. For example, .005% of GMC stock would probably not be a qualified stock investment.

out of the United States because an increase in U.S. net equity will have resulted from this corporate liquidation. If the target corporation for purposes of the stock purchase exception is a foreign corporation, then presumably one would also "look through" to the target's assets used in a U.S. trade or business, as is done for a U.S. corporation.

G. Non-U.S. Capital Expenditures

As provided by IRC section 884(c)(2)(C) and Treasury Regulation section 1.882-5, U.S. business-connected liabilities can be determined by one of two methods, at the taxpayer's election. The first alternative is to divide the average worldwide liabilities by the average worldwide assets—at their adjusted tax basis or fair market value, but not earnings and profits basis. This fraction is then multiplied by the average amount of U.S. business-connected assets as defined above. The alternative is to multiply a fixed 50 percent rate by the amount of U.S. business-connected assets.

The amount of U.S. business-connected liabilities thus has no causal connection with the incurrence for or reasonable needs of the U.S. business. A Taiwan building constructed with debt proceeds will decrease U.S. net equity and increase the U.S. branch profit tax on the other side of the globe. Alternatively, a New Orleans building constructed with debt proceeds will increase U.S. net equity and allow the U.S. branch to send some branch assets overseas without triggering the branch profit tax.

These results can be illustrated mechanically as follows:

	Before additional non-U.S. debt	**After additional non-U.S. debt**
Average Worldwide Liabilities / Average Worldwide Assets	2/3 = 66%	3/4 = 75%
U.S. Business-Connected Assets	×2	×2
U.S. Business-Connected Liabilities	1.3	1.5
U.S. Net Equity	.7	.5
Construct United States Building:		
	Before additional U.S. debt	**After additional U.S. debt**
Liability/Asset Ratio (Above)	66%	75%
U.S. Business-Connected Assets	×2	×3
U.S. Business-Connected Liabilities	1.3	2.2
U.S. Net Equity	.7	.8

A better method to calculate U.S. business-connected liabilities would require that worldwide liabilities at the end of the tax year be assigned to the country that used their proceeds. Of course some liabilities will inevitably exist whose proceeds were used for general corporate purposes in which all countries benefited. The ratio approach now codified in the tax law could be used for those liabilities that cannot be assigned to any country.

As one might expect, the wild fluctuations in the "U.S. net equity" caused by foreign debt issuances are likely to cause overtime hours for accountants, lawyers, and financiers. One possible alternative would be to lease, rather than purchase, the assets. The lease might have to be capitalized as property and debt for financial statement purposes. Neither Treasury Regulation section 1.882-5 nor applicable case law dictates whether liabilities should be determined using financial accounting or tax principles. If the taxpayer uses the adjusted tax basis of assets to compute the ratios discussed above, it would be anomalous to include lease liabilities that are not debt under tax principles since the assets, at adjusted tax basis, would not include such leased assets. It would seem to follow, if only in the interest of equality and simplicity, that all methods under Treasury Regulation section 1.882-5 should use only liabilities established under tax principles. Another alternative would be to incorporate the U.S. branch as a U.S. corporation and avoid the branch profit tax.[36]

H. Foreign Corporations Owned by U.S. Residents

Perhaps the greatest oddity of the new branch profit tax is that it applies to all foreign corporations regardless of ownership. United States earnings distributions to U.S. shareholders will now experience at least three levels of income tax—the regular U.S. income tax, the branch profit tax, and the individual income tax paid by the dividend recipient. Again, a possible solution would be to spin-off the U.S. business into a U.S. corporation to avoid the branch profit tax.

The purpose of the branch profit tax was to reduce the disparity between U.S. earnings distributions by U.S. corporations and foreign corporations with a U.S. branch where the corporations are owned by nonresidents.[37] The tax disparity between the two modes of operation was the possible avoidance of the 30 percent withholding tax on dividends that applies only if the shareholders are nonresidents. It seems improper to impose the branch profit tax to the extent a proportionate part of the U.S. earnings are attributable to the U.S. residents' ownership.

36. I.R.S. Notice 86-17, 1986-52 I.R.B. 19.
37. Senate Finance Report, *supra* note 13, at 400-01.

By the same token, however, the branch profit tax does not apply to U.S. corporations.[38] This circumstance will encourage multinational corporations to domicile in the United States and allow the U.S. earnings to be exported to non-U.S. operations of the U.S. corporation. Such an outcome is probably not a great threat because a U.S. domicile will expose all of the international earnings to both the regular U.S. tax and to the U.S. dividend withholding tax (usually 30 percent) under IRC section 881(a) because the dividends are U.S. source under IRC section 861(a)(2)(A).

I. Impact on Treaties

If the foreign corporation is a "qualified resident" of the treaty country, then the applicability of the branch profit tax and the rate to be applied is to be determined by the treaty. If the foreign corporation is a qualified resident of the treaty country, then the Conference Committee Report provides that no branch profit tax will be imposed if the treaty contains the nondiscrimination clause similar to that contained in article 24(3) of the United States 1981 Model Income Tax Treaty.[39] Additionally, if the tax treaty contains an article limiting the regular U.S. income taxes to permanent establishments, the Conference Committee Report provides that no branch profit tax will be imposed if a permanent establishment does not exist and the foreign corporation is a qualified resident of the treaty country.[40]

If the treaty does not preclude the branch profit tax, then the treaty's branch profit calculation and branch profit tax rate will be used as provided by IRC section 884(e)(2)(A)(i). If the treaty does not discuss the branch profit tax, then IRC section 884(e)(2)(A)(ii) provides that the dividend equivalent amount under IRC section 884(a) will be used, and the treaty's dividend withholding rate will be used if lesser than 30 percent.

If the foreign corporation is not a qualified resident of the treaty country, then the Senate Finance Report provides that any treaty provisions prohibiting a branch profit tax or dividend withholding tax are to be ignored.[41] If the treaty allows a second level dividend withholding tax and the foreign corporation actually pays dividends subject to the dividend withholding tax, then under IRC section 884(e)(1)(B), no branch profit tax is imposed. IRC section 884(e)(3)(B) provides that the withholding rate is 30 percent regardless of a lesser treaty rate. If the dividends are not subject to withholding because of the Code's 25 percent threshold or greater treaty

38. *See* I.R.C. § 884(a).
39. Conference Committee Report, *supra* note 12, at 650.
40. *Id.*
41. Senate Finance Report, *supra* note 13, at 405.

threshold, or because no dividends are paid by the foreign corporation, the branch profit tax may be imposed at 30 percent if the U.S. earnings are not reinvested.[42]

Prior to the Tax Reform Act of 1986, the minimum amount of gross income from a U.S. business sufficient to subject a portion of the foreign corporation's earnings and profits to the dividends withholding tax was 50 percent under IRC section 861(a)(2)(B). The Tax Reform Act of 1986 changed this threshold to 25 percent under new IRC section 861(a)(2)(B). Many treaties contain gross income thresholds of 50 percent. The change to 25 percent by the Tax Reform Act of 1986 appears not to have been meant to override these higher treaty threshold requirements for regular withholding requirements even in treaty shopping situations. For example, the Senate Finance Report suggests that if a treaty permits a second level dividend withholding amount when gross income from a U.S. business exceeds 50 percent and such dividends are paid when this threshold is met, no branch profit tax is imposed even in treaty shopping situations.[43] This comment is significant since it appears in the same topical section of the Senate Finance Report as the discussion of the Code's decrease in the threshold percentage.

J. Treaty Shopping—"Indirect Base Erosion"

A foreign corporation is not treaty shopping, and thus entitled to treaty benefits, if it is a qualified resident of the treaty country. Under IRC section 884(e)(4)(A), a foreign corporation that is a resident of a foreign country is also a qualified resident of that foreign country if:

(i) at least 50 percent (by value) of the foreign corporation's stock is owned, with certain attribution and look-through rules, by individuals who are residents of the foreign country or United States citizens or resident aliens, and

(ii) less than 50 percent of its income is used (directly or indirectly) to meet liabilities to persons who are not residents of such foreign country or the United States.

The issue to be discussed is the meaning of "indirectly" in clause (ii) above. Other writers have excellently discussed the stock ownership test.[44]

The meaning of "indirectly" is not addressed in the Conference Committee Report.[45] The Conference Committee Report provides that where

42. I.R.C. § 884(e)(1)(B).

43. Senate Finance Report, *supra* note 13, at 405.

44. *See e.g.*, N.Y. State Bar Association Tax Section, *The Branch Profit Tax—Report on Issues to be Addressed in Regulations* 34 Tax Notes 607 (1987).

45. Conference Committee Report, *supra* note 12, at 649.

50 percent or more of a foreign corporation's income is used to satisfy liabilities outside the corporation's country of residence, the corporation may not avail itself of any treaty benefits between its country of residence and the United States (a "base erosion" rule). This rule is frequently used in recent U.S. income tax treaties and the conferees felt that its addition was necessary to prevent nonresidents of a treaty country from gaining benefits accorded by the treaty.[46]

The U.S. income tax treaties with both the Republic of Cyprus and Barbados contain comparable provisions limiting treaty benefits. Under article 26 of the United States—Cyprus income tax treaty, a person may not claim treaty benefits unless the gross income of such person is not used in substantial part, directly or indirectly, to meet liabilities, including liabilities for interest and royalties, to persons who are not residents of the Republic of Cyprus and are not U.S. citizens.[47] Article 22(1)(6) of the United States—Barbados income tax treaty contains a similar provision limiting treaty benefits.[48]

The U.S. Treasury Department has explained that "liabilities," for purposes of this provision of the United States—Cyprus income tax treaty, means deductible expenses and includes liabilities for interest. The reference to "deductible expenses" is apparently determined under the law of the foreign country.[49]

With this legislative history as guidance, the term "indirect" payments might apply, for example, to back-to-back interest payments from a Netherlands corporation operating in the United States to a Netherlands affiliate in which the Netherlands affiliate then pays liabilities to persons neither residents of the Netherlands nor citizens of the United States. This approach now applies to back-to-back interest payments and could be adopted for purposes of the branch profit tax.[50]

Even if these payments are considered to be made to third-country recipients, however, they should not be considered "base erosion" payments when a U.S. tax treaty with the ultimate recipient's country of residence has dividend provisions similar to those of the payor's country of residence. The branch profit tax is aimed at dividends avoidance, and

46. *Id.*

47. Convention for Avoidance of Double Taxation, Mar. 19, 1984, United States—Cyprus, art. 26(1)(b), 1 Tax Treaties (CCH) ¶ 2029 (Apr. 1984).

48. Convention for Avoidance of Double Taxation, Dec. 31, 1984, United States—Barbados, art. 22(1)(b), 1 Tax Treaties (CCH) ¶ 5792 (Feb. 1985).

49. Treasury Department Explanation of the Convention for Avoidance of Double Taxation, Mar. 19, 1984, United States—Cyprus, *reprinted in* 1 Tax Treaties (CCH) ¶ 2036, at 2027-30 (Aug. 1985).

50. Rev. Rul. 84-152, 84-153, 1984-2 C.B. 381-4.

a direct stock investment by the third country investor would not have changed the U.S. dividend withholding requirements.

Returning to the question of "indirect" payments, the IRS may require that, even in the absence of back-to-back loans, the foreign corporation operating in the United States and the foreign affiliate-recipient combine their gross income and expenses for purposes of this base erosion test. Under an appropriate set of facts, this procedure may result in the loss of qualified resident status for the foreign corporation operating in the United States.

Except in cases of consolidated returns, joint returns, and other provisions statutorily provided by Congress, each entity stands as a separate taxpayer for purposes of applying the Internal Revenue Code. The IRS has so recognized this principle in Treasury Regulation section 1.482-1(b)(3). Nothing in the Internal Revenue Code prohibits the use of multiple entities to conduct business operations that could otherwise be effected in one entity.[51] The Code, however, places statutory limitations on certain tax benefits, such as IRC section 1551 limiting the surtax exemption benefit.

If the business purposes of the entity, other than tax reduction, are insignificant, then the tax significance of an entity may evaporate.[52] If the foreign affiliate recipient were a viable entity operating in the foreign country, it would not seem appropriate to combine its income with the foreign corporation operating in the United States for purposes of the 50 percent base erosion test. The regulations should address this issue either under IRC section 884(e)(4)(A) or IRC section 884(e)(4)(C).

K. Interest Paid by the U.S. Branch

IRC section 884(f)(1)(A) imposes a withholding tax on the creditor equal to 30 percent of the interest paid by the branch, unless a lesser treaty rate applies. This provision contains no minimum gross income threshold percentage as under earlier law. The only requirement is that the foreign corporation be engaged in a U.S. trade or business.[53] This provision is not meant to be more favorable than prior law. For example, the absence of regular U.S. income taxation, perhaps due to a permanent establishment requirement, did not prevent the interest withholding tax under prior law[54] and in the absence of contrary legislative history, should not prevent the new interest withholding tax. Unless a disparity exists between the asset/income ratios of U.S. and foreign operations, the interest compu-

51. Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943).
52. National Investors Corp. v. Hoey, 144 F.2d 466 (2d Cir. 1944).
53. I.R.C. § 884(f)(2).
54. I.R.C. § 861(a)(1)(C).

tations under IRC section 884(f) and IRC section 882 will approximate the interest computations under IRC section 861(a)(1)(C) using gross income ratios under prior law. Of course, treaty considerations may preclude the interest withholding provisions of IRC section 884(f)(1)(A) or the direct corporate tax on "excess interest" under IRC section 884(f)(1)(B) if the creditor-recipient or the foreign corporation operating in the United States is a qualified resident of the treaty country.[55]

The Committee Reports do not discuss the determination of interest paid by the branch. It would seem that any home office charges against the branch should qualify so long as the branch maintains corresponding books and records. One question is whether interest passed through from a partnership interest will be considered paid by the United States branch.

If the U.S. branch pays more interest than the amount deductible under IRC section 882, this interest would presumably be subject to withholding under IRC section 884(f)(1)(A). Of course, all of these rules are subject to treaty limitations if the interest recipient is a qualified resident of a treaty country.[56] In addition, no withholding would be required if the interest is otherwise exempt under a Code provision. Examples of exemptions would be interest on deposits with persons engaged in the banking business under IRC section 871(i)(2)(A), original issue discount on certain short-term debt under IRC section 871(g)(1)(B), and portfolio interest under IRC section 881(c).

L. Excess Interest

Under the interest allocation rules of Treasury Regulation section 1.882-5, the U.S. branch will be allocated interest expense for computing the foreign corporation's effectively connected U.S. taxable income. This interest expense allocated to the U.S. branch may exceed the amount paid by the U.S. branch under IRC section 884(f)(1)(A). This "excess interest" will be subject to a 30 percent tax imposed directly on the foreign corporation rather than the interest recipient, unless the interest is exempt by treaty or Code provision or a lower treaty withholding rate exists. The interest is considered paid by a domestic corporation to the foreign corporation actually operating in the United States.[57] Thus, any applicable treaty is the treaty between the United States and the country of residence of the foreign corporation operating in the United States, and the parent-subsidiary withholding rate would apply.

55. I.R.C. § 884(f).
56. Conference Committee Report, *supra* note 12, at 649.
57. I.R.C. § 884(f)(1)(B).

The amount of interest allocated under Treasury Regulation section 1.882-5 is determined by calculating the amount of U.S.-connected liabilities. This amount can be either the ratio of worldwide liabilities to worldwide assets multiplied by U.S.-connected assets, or 50 percent multiplied by U.S.-connected assets. The taxpayer then has a choice between two calculations. The first calculation provides interest expense equal to the liabilities shown on the branch books times the branch's average interest rate paid plus the result of multiplying U.S.-connected liabilities in excess of the amount shown on the branch's books by the average interest rate paid on such excess liabilities. An alternative method pools the branch's liabilities by currency: The ratio of the U.S.-connected liabilities to the average total branch-book liabilities times the average branch-book liabilities in that currency multiplied by the foreign corporation's, not the branch's, average effective interest rate on such currency.

The Conference Committee Report provides that any Code exemptions will apply to such "excess interest" by mirroring the foreign corporation's external borrowing by reference to the relative principal amounts of, and average interest rate on, each type of external borrowing.[58] The normal Code exemptions are those of portfolio interest, bank deposit interest, and original issue discount on short-term debt, all discussed earlier. Because any exemptions are to mirror the foreign corporation's external borrowing, it is uncertain whether relief will exist when a portion of the external borrowings are owed to United States citizens or corporations that would be exempt from the withholding tax. This situation is further complicated by the Code's treatment of the excess interest as interest paid by a domestic corporation to a foreign corporation.[59] To obtain any treaty relief, the foreign corporation and not the creditors underlying such excess interest must be the qualified resident of its country.[60]

M. Triggering of Interest Tax

While in most cases the foreign corporation will have a permanent establishment in the United States and be subject to the regular income tax, more than a few cases will arise when the U.S. operations are not subject to either the regular U.S. income tax or the branch profit tax. In these cases it will be unusual to expect a tax on interest, but the answer is not clear. If the interest is not protected by a Code exemption or a treaty provision, IRC section 884(f)(1) clearly requires that, if a foreign corporation is engaged in a U.S. trade or business, any interest paid by

58. Conference Committee Report, *supra* note 12, at 649.
59. I.R.C. § 884(f)(1)(B).
60. Conference Committee Report, *supra* note 12, at 649.

the branch and any "excess interest" will be subject to a 30 percent tax. Actual taxation for either the regular U.S. income tax or the branch profit tax is not a prerequisite to the tax on interest. The staff of the Joint Committee on taxation believes, however, that the tax is applicable to "deductible" interest.[61]

If a treaty of a country in which either the foreign corporation or the creditor is a qualified resident does not limit interest taxation to amounts attributable to sources from a U.S. permanent establishment, then absent a lower treaty rate or Code exemption, Treasury regulations should clarify whether such interest will be subject to withholding, notwithstanding that no income tax or branch profit tax is imposed on the U.S. operations.[62]

N. Back-to-Back Loans

The Conference Committee expressed concern that the new interest taxation provisions would increase the use of back-to-back loans by non-treaty residents. These types of loans, as under present law, are to be collapsed by the IRS.[63]

One example of when this situation might occur is when the entity operating in the United States is a domestic corporation. Since IRC section 884(f) only applies to foreign corporations, the treaty shopping rules of IRC section 884(e)(3)(B) are not applicable. Thus, the creditor need not be a qualified resident of a treaty country—either in terms of ownership, IRC section 884(e)(4)(A)(i), or in terms of operations, IRC section 884(e)(4)(A)(ii). The IRS has already ruled that the appropriate treaty, if any, is the treaty between the United States and the ultimate creditor.[64] In this type of situation, a loan from a Peruvian corporation to a Netherlands Antilles corporation, followed by a loan from the Netherlands Antilles corporation to the U.S. corporation, would not qualify for treaty benefits because the appropriate treaty, under Revenue Rulings 84-152 and 84-153, would be the treaty between the United States and Peru, of which none exists.

Another example might be when the foreign corporation and existing creditors of the foreign corporation are not qualified residents of a treaty country, but a potential creditor is such a qualified resident. The foreign corporation might enlarge its liabilities to such qualified resident creditor, thus creating interest expense allocable to the U.S. branch and reducing

61. Joint Committee on Taxation, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986 (Comm. Print 1987).

62. *See e.g.*, Peter H. Blessing's excellent discussion of possible treaty limitations, Blessing, *The Branch Tax*, 40 Tax 587 (1987).

63. Conference Committee Report, *supra* note 12, at 650.

64. Rev. Rul. 84-152, 84-153, *supra* note 50.

both the regular U.S. income tax and the branch profit tax. The interest would not be subject to U.S. tax under IRC section 884(f)(1)(A) if paid by the U.S. branch. If the qualified resident creditor borrowed its funds from the foreign corporation in a related transaction, these transactions might be collapsed and the loans and related interest ignored. If the potential creditor obtains its funds from an unrelated source, this scheme might reduce both the regular U.S. income tax and the branch profit tax if the foreign home office invests the funds in non-U.S. source investments because such investment income, if non-U.S. source, would not be subject to taxation if not connected with a U.S. trade or business. Yet, a portion of the interest expense will be allocated to the U.S. branch under Treasury Regulation 1.882-5.

O. Capitalization

If the foreign corporation does not have favorable treaty benefits regarding interest, or if the foreign corporation is not a qualified resident of its country, then debt of the foreign corporation to nonqualified residents should be minimized because, under the interest expense allocation rules of IRC section 882, at least a portion of such interest will be considered connected with the U.S. operations and thus exposed to the excess interest tax of IRC section 884(f)(2) unless a Code exemption exists. At issue is whether all interest of the foreign corporation may be paid by the U.S. branch to take advantage of any benefits under the treaty with the interest recipient's country of qualified residence under section 884(f)(1). Such "excess payments," however, could possibly trigger the branch profit tax because these cash payments in excess of deductible amounts will reduce "U.S. net equity" and increase the "dividend equivalent" amount discussed below. Surprisingly, because the actual interest payments by the U.S. branch are considered to be made by a U.S. corporation, the foreign corporation may now be capitalized with portfolio debt and avoid any withholding on the interest.

P. Flexible Interest Payments

These "qualified residence" tests apply to moving targets. In the case of the branch profit tax, the qualified residence tests apply only to the foreign corporation operating in the United States.[65] In the case of the second level dividend withholding tax, the qualified residence tests apply to both the foreign corporation operating in the United States, as payor,

65. I.R.C. § 884(a) (Supp. IV 1986).

and its foreign corporate parent, as recipient.[66] In the case of the interest "paid" withholding tax, the qualified residence tests apply to the foreign recipient or the foreign corporation operating in the United States if the treaty has a "source" interest provision in the case of interest actually paid by the branch.[67] In the case of "excess" interest deducted by the branch, the relevant tax treaty is the treaty between the United States and the foreign corporation's home office,[68] and the qualified residence tests apply only to the foreign corporation operating in the United States.[69]

Depending on the withholding tax provisions on interest of the various applicable treaties, the U.S. branch should either increase or decrease its actual interest payments to utilize the withholding tax provisions on interest of the most favorable treaties. This flexibility in actual interest payments by the branch should not affect the branch profit tax because any increase in IRC section 884(f)(1)(B) "excess" interest will decrease U.S. earnings but will not affect U.S. net equity. Accordingly, an amount of U.S. assets equal to the "excess" interest amount may be exported without imposition of the branch profit tax. The branch profit tax is not affected by whether interest is paid by the U.S. branch or allocated to the U.S. branch. This situation can be illustrated as follows:

U.S. Earnings pre-interest expense allocation		$300	
IRC § 882 interest allocated in excess of actual branch payments			(100)
U.S. Earnings and Profits		200	
Increase in U.S. Net Equity			
	Beginning of Year	**End of Year**	
Branch Assets—Earnings and Profits Basis	$200	$500	
Allocated Branch Liabilities	(150)	(150)	
	50	350	
Beginning of year U.S. Net Equity		50	
Increase in U.S. Net Equity		300	(300)
Excess that may be returned to foreign home office		100	

66. I.R.C. § 884(e)(3)(B)(i), (ii).
67. IRS Notice 87-56, *supra* note 2.
68. CONFERENCE COMMITTEE REPORT, *supra* note 12, at 649.
69. *Id.*

Because the branch profit tax is due annually, the qualified residence tests are presumably applied annually, and are probably subject to IRS adjustments for tax-motivated year-to-year changes in the 50 percent base erosion tests and dividend payments. For example, payments to third-country creditors could be unusually trimmed to below the 50 percent threshold in the same year that U.S. earnings are exported. This would appropriately arouse suspicion and nontax business motivation would have to be assessed.

Q. Impact on Nontreaty Countries

The enactment of IRC section 884 may possibly be an unexpected benefit to foreign corporations residents of countries whose treaties do not provide second level withholding benefits, and that do not prevent the branch profit tax, or to foreign corporations residents of countries in which no tax treaty with the United States exists. In these cases, no second level withholding tax on pre- or post-1987 dividends will be imposed even though no branch profit tax is imposed—for example where U.S. earnings are reinvested—even though a second level withholding tax would have been imposed had IRC section 884 not been enacted.[70]

R. Nontax Considerations

A U.S. corporation will be subject to certain U.S. laws that a foreign corporation operating in the United States is less likely to encounter. A U.S. corporation is more likely to be subject to U.S. antitrust laws,[71] trademark laws,[72] antitrust laws (even when trademarks are valid under

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70. I.R.C. § 884(e)(3)(A).

71. Generally, United States antitrust laws apply to foreign transactions that affect United States imports, United States v. Aluminum Co. of America, 148 F.2d 416, 443 (2d Cir. 1945), and with certain exceptions, not to United States exports Foreign Trade Antitrust Improvements Act of 1982, Pub. L. No. 97-290, § 402 (codified as amended at 15 U.S.C. § 6a (1982)). If the United States imports are affected by a method that violates either the Sherman Act of 1890, the Clayton Act of 1914, or the Robinson-Patman Act of 1936, then the domicile of the defendants (i.e., domestic vs. foreign) is one of the factors to be considered in exercising jurisdiction by United States courts (at least in the Third and Ninth Federal Circuits). Timberland Lumber Co. v. Bank of America, 549 F.2d 597, 614 (9th Cir. 1976); Mannington Mills, Inc. v. Congoleum Corp., 595 F.2d 1287, 1297-98 (3d Cir. 1979).

72. United States trademark laws generally apply extraterritorially to improper foreign use of a United States trademark when such improper use affects United States commerce or foreign commerce. American Rice, Inc. v. Arkansas Rice Growers Coop. Ass'n, 701 F.2d 408 (5th Cir. 1983). This jurisdictional reach afforded to United States courts is limited by the Paris Convention for the Protection of Industrial Property (Paris Union), Mar. 20, 1883, *as revised* July 14, 1967, 21 U.S.T. 1583, 828 U.N.T.S. 305, T.I.A.S. No. 6923, Vanity Fair Mills, Inc. v. T. Eaton Co., 234 F.2d 633 (2d Cir. 1956); and by the domicile of the defendants or their subsidiaries, Wells Fargo & Co. v. Wells Fargo Express Co., 556 F.2d 406, 428 (9th Cir. 1977); American Rice 701 F.2d at 416.

both U.S. and foreign law),[73] the Foreign Corrupt Practices Act,[74] and the Arab Boycott regulations.[75] A U.S. corporation and a foreign corporation appear to be equally subject to U.S. laws limiting the export of technology or goods in short supply.[76]

If there exists a discriminatory impact on imports, for example, if statistically, more imports enter via foreign corporations, then perhaps the General Agreement on Tariffs and Trade has been violated.[77] This discrimination may also violate the fifth amendment due process clause.[78]

IV. Summary

Absent back-to-back loan arrangements such as those discussed in Revenue Rulings 84-152 and 84-153,[79] a foreign investor, whether shareholder or creditor may "treaty shop" as long as a U.S. corporation is used to conduct the U.S. business. As a result, it will almost always be beneficial to use a U.S. corporation to protect treaty benefits in treaty-shopping situations. For example, a third-country investor could establish a parent company in a treaty country, which would then own the U.S. operating

73. *See* Timken Roller Bearing Co. v. United States, 341 U.S. 593 (1951) (a United States corporation may not enter market-share agreements with affiliated foreign corporations even if the affiliated group possesses valid registered trademarks in all of the affected countries). Oddly enough, after the Supreme Court's decision, the United States Department of Justice permitted Timken Roller Bearing to merge all companies into one company. The divisions of the resulting company then performed the same market-share allocations as before under its trademarks registered in each country. *See* Markley, *How Timken Coordinates Its Worldwide Manufacturing and Marketing*, EXPORT TRADE, Apr. 25, 1960, at 10.

74. The United States Foreign Corrupt Practices Act of 1977 criminalizes bribery of foreign officials (beyond the "grease" level of small payments to low-level officials). 15 U.S.C. § 78dd-1 (1982). United States corporations are automatically subject to the Act. 15 U.S.C. § 78dd-2. By comparison, a foreign corporation is subject to the Act only if its principal place of business is in the United States. 15 U.S.C. § 78dd-2.

75. United States corporations are automatically prohibited from complying with the Arab boycott against Israel whereas only foreign corporations with a permanent United States establishment are similarly prohibited. 50 U.S.C. app. §§ 2407(a)(1), 2415(2) (1982).

76. Export restrictions on technology or goods apply if these items are subject to the jurisdiction of the United States or exported by any person subject to the jurisdiction of the United States. 50 U.S.C. app. § 2404(a) (1982) (relating to export control of technology) and 50 U.S.C. app. § 2406(a) (1982) (relating to export control of goods in short supply).

77. General Agreement on Tariffs and Trade, Oct. 30, 1947 (*as amended*), art. III, ¶ 2, 55 U.N.T.S. 194, 61 Stat. (5), (6), T.I.A.S. No. 1700, provides that "[t]he products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products."

78. *See* Bolling v. Sharpe, 347 U.S. 497 (1954) (extending the equal protection clause of the 14th Amendment to the federal government under the 5th Amendment due process clause) Metropolitan Life Insurance Co. v. Ward, 105 S. Ct. 1676 (1985) (applying such equal protection rights and declaring a state tax that discriminated against foreign corporations as unconstitutional).

79. CONFERENCE COMMITTEE REPORT, *supra* note 12, at 649.

company. One exception to this rule is where a treaty would prevent regular U.S. income taxes in the absence of a permanent establishment.[80] A less typical exception would be where the income is not effectively connected for purposes of regular U.S. income taxes. In both situations a U.S. corporation is, and a foreign corporation usually is not, subject to regular U.S. taxes.

If the foreign investors, whether shareholders or creditors, are qualified residents of the applicable treaty country, then, unless the treaty prevents the branch profit tax, the form in which the business is conducted makes no difference because the export of the U.S. earnings will be taxed generally at the same rate and the same amount. If the treaty does prevent the branch profit tax, a foreign corporation operating in the United States will still be able to export U.S. earnings to non-U.S. operations as before. If the treaty benefits of the "qualified resident" country are not as great as other treaties, it may be better for the foreign investors to "treaty shop" and use a U.S. corporation.

80. CONFERENCE COMMITTEE REPORT, *supra* note 12, at 650 (by implication).